



FLAG MONTENEGRO

CALENDAR YEAR 2001- 3rd QUARTER REPORT

JULY 1 - SEPTEMBER 30, 2001

INTRODUCTION

Except with regard to summer tourist activities, the third quarter of 2001 saw a slowdown in Montenegrin economic activity owing largely to the traditional August holiday and the fact that necessary institutional reforms have yet to be implemented. The unresolved issue of Montenegrin independence continues to hamper economic relations with Serbia, Montenegro's largest potential market, and causes potential foreign partners and investors to be wary. In spite of this, FLAG Montenegro's assistance to SMEs resulted in a number of successes in this quarter as SME activities accelerated following the release of additional USAID funding late in the second quarter of 2001.

Unfair competition from the gray market continues to create problems for businesses seeking foreign partners and wishing to operate transparently in a normalized market economy. FLAG Montenegro's assistance is directed at helping those businesses with solid management and the desire to operate transparently to succeed in the current environment while also training them for operations and management in a fully modern market economy.

Management assistance activities at Kombinat Aluminijuma Podgorica (KAP) have been largely successful in terms of training management personnel, but frustrating with regard to the implementation of needed changes. Many operational initiatives were hampered by KAP's continuing inability to resolve issues with creditors on the debt restructuring agreement (DRA). Once this hurdle is cleared, KAP will have immediate access to a USD 11.3 million credit line that will enable it to acquire needed inputs and make critical improvements to its plants. Notwithstanding these challenges, it is still believed that this will be the first year in a decade in which KAP will show a positive net income.

SMALL AND MEDIUM ENTERPRISE DEVELOPMENT

Technical Assistance

FLAG's SME activities increased dramatically in the third quarter of 2001 as we refined our client database and identified a number of key projects. Currently, we have a database of 44 active clients and 243 inactive clients. Active clients are those to whom we have provided technical assistance (TA) including the following: recruitment of consultants, development of strategic plans, market research, development of business plans, and/or direct consulting advice. Inactive clients include clients that we have graduated¹, those for whom we have researched trade leads without further TA follow up, or those with whom a relationship has just started.

FLAG has been able to be more selective in choosing those clients who warrant extensive TA, and has concentrated on working with promising firms that appear to be genuinely viable, have relatively forward-thinking managements, offer trade potential, or provide services to such companies.

Given the relative trade advantages of the wood and metal processing sectors in Montenegro, we have begun large-scale market surveys of these industries. These surveys will enable FLAG to target the TA through increased value-added processing based on the needs of the international market, eliminating middlemen who sell semi-processed goods abroad, and building business plans that will provide financing to businesses in these sectors to help them increase trade and revenues.

Selected SME Projects

Company Name: UNA; Location: Tivat

TA Requested & Identified: Management & Marketing

Products/Services: Ropes, Nets, Marine Equipment & Accessories

Industry: Marine Equipment and Services

Status: Executed -- Follow-up TA is being administered

¹ Graduated clients are those with whom work has concluded due to lack of cooperation, successful completion of requested assistance, or lack of business viability.

Summary: FLAG Montenegro recruited and supported a volunteer consultant who worked with UNA for two weeks in developing an organizational structure that will help the owner better manage his operations. We made many recommendations for improving the rope making process, which included acquiring more modern machinery. Progress was also made in establishing a cost accounting program so the owner will know which products are profitable and where sales and marketing efforts should be concentrated. The expert proved invaluable not only in providing direct technical assistance and training local staff, but also by providing linkages to suppliers of raw materials and manufacturing equipment. Following the program outlined by the expert is expected to yield a year-on-year increase in revenues of 15% by 2002.

Montekuk – Nikšić

TA Requested & Identified: Marketing & Sales Strategy

Products/Services: Soft drinks, syrups

Industry: Beverages

Status: Executed -- Follow-up TA is being administered

Summary: We recruited and worked with a volunteer who is a former international marketing executive for Schweppes. We formulated marketing and sales plans to expand operations in Montenegro. Strategies include repackaging the soft drinks into more attractive containers, enhancing the labels to reflect the natural product, in-store test marketing, and the possible introduction of generic brands. After meeting with potential distributors, our client agreed to a test marketing program and promotional strategy that is expected to increase revenues by 20% and increase employment by 30%.

OD Trio Martinovic – Podgorica

TA Requested & Identified: Marketing & Sales Strategy

Products/Services: Soft drinks, syrups

Industry: Beverages

Status: Executed -- Follow-up TA is being administered

Summary: Not quite as large a firm or as cooperative as Montekuk, OD Trio Martinovic does not have a carbonated line of juice products and is only producing pulp fruit juice. We prepared a marketing strategy similar to what was recommended for Montekuk. Focusing on promotional efforts for its products and implementing the new strategy, OD Trio Martinovic should be able to increase year-on-year revenues by 20%.

Doding – Podgorica

TA Requested & Identified: Operations & Marketing Strategy

Products/Services: Wood Furniture, Distributor of Wood Closets

Industry: Furniture

Status: Executed -- Follow-up TA is being administered

Summary: We worked with a team of volunteers to provide technical assistance in assessing the operations for Doding, making recommendations on future expansion and new product opportunities, as well as preparing a marketing strategy that leverages their presence in Bosnia - Herzegovina, Croatia, and Serbia. Doding has clear direction, progressive management, and an opportunity to grow throughout the Balkan Region. With 27 employees and sales of 360,000 DEM in 2000, Doding is projected to increase employment by 30% and sales by 20% in 2002 based on the plans we developed for them. They have embraced the proposed marketing strategy and will continue implementation with assistance from FLAG.

Simles – Podgorica

TA Requested & Identified: Operations & Marketing Strategy

Products/Services: Natural Wood Furniture

Industry: Furniture

Status: Executed -- Follow-up TA is being administered

Summary: Initial assessment by FLAG suggests that Simles has many challenges to overcome in order to be competitive within the furniture industry. Contrary to the opinions of the current owner/manager, based on a market analysis, many of his company's products cannot be made with its current technology at a sufficient quality to compete, and the outsourcing of necessary parts creates a significant cost constraint in production and assembly. Much of its limited capital has been utilized to supply showrooms presenting products that are not, in fact, available for production due to the aforementioned constraints. Marketing and sales tactics have been presented to the company, including producing a sales brochure and a low-cost advertising campaign. In the next quarter, cost accounting assistance will be provided to Simles to help formulate a better production strategy and find ways to better utilize capital, thus enabling Simles to finance equipment that will produce the high-quality natural wood products it showcases.

Riva – Herceg Novi

TA Requested & Identified: Product Design & Marketing Strategy

Products/Services: Metal Furniture, Industrial Furniture

Industry: Metal Products and Furniture

Status: Executed -- Follow-up TA is being administered

Summary: Supplying quality metal furniture to cafe bars, restaurants, and hotels throughout Montenegro, Riva wants to continue to focus on this market and not delve into any new markets as suggested by FLAG. We continue to work with this client to help it utilize its excess capacity and increase off-season production and expand into foreign markets. Recommendations were made to leverage Riva's core products of metal & plastic chairs and provide these products to exhibition halls, to companies exhibiting at trade shows, and to distributors who work within this market segment. It is projected that Riva could market a Montenegrin product within this segment throughout the Balkans, increasing sales by a projected 30% and increasing full-time employment by 50%.

Aroma – Podgorica

Vidrovan – Podgorica

TA Requested & Identified: Marketing & Organizational Management

Products/Services: Essential Oils, Dry Herbs

Industry: Herbs and Essential Oils

Status: In-process

Summary: We have provided TA in cooperation with a US-based expert with direct industry experience providing guidance in collecting and packaging samples for testing by a US firm. We are waiting for final results of this testing and, if deemed marketable, we will make suggestions on quality control methods and product lines to produce and market the essential oils on the world market. Most of the products are currently exported to EU countries via trade companies located in Belgrade. We are working with the companies to develop their sales and trade functions to enable direct sale of their production to the US and European markets.

Ditta – Kolašin

Trgoprodukt – Pljevlja

Duga Dit – Nikšić

TA Requested & Identified: Marketing & Business Plan Development

Products/Services: Beech wood products, parquet floors

Industry: Wood Processing

Status: In-process

Summary: Market research and preliminary business analysis began at the end of the quarter. Business plans are scheduled to be complete in the final quarter of CY2001. See below “Business Plans & Market Research” for further details. The initial plans for one company, Ditta, could result in revenue increases of 300% by the end of 2002. Ditta, a producer of customized beechwood products plans to expand its operations to include a new finishing process. Duga Dit produces parquet floors and tables and is looking for a business plan to expand its operations into furniture production.

Tourism Industry Clients

There are four clients who are looking at either expanding existing private hotel operations or who want to build a new hotel altogether. FLAG also has clients who want to build or design complementary tourist products that include restaurants, sightseeing tours, and a golf course. These ideas are being screened for feasibility, and business plans will be produced for those ideas that are feasible based on market analysis and the financial capacity of the client.

Linkages

Providing business connections, both domestically and internationally, continues to be one of the most helpful services we provide to the SME sector. This past quarter we had 35 requests from clients including locating suppliers of quality control equipment for meat processing, suppliers of glass juice bottles, suppliers of mattress material, suppliers of raw materials for nets and ropes, suppliers of high-frequency induction welders, and customers within the hospitality industry who might use the products and services of our SME clients.

One example of a successful business connection is with our client UNA, manufacturer of rope, nets, and marine products. UNA is in a highly specialized industry that presents special challenges but, upon completing an evaluation of UNA’s current business status, we were able to provide contacts in Norway, England, the US, South America, and Italy. UNA’s needs have led the business to form a relationship with an Italian supplier of raw material. Representatives from an Italian company, who provided UNA with a quality shipment of raw material in September, are scheduled to visit UNA’s operation and solidify a partnership. For this SME with 24 employees, such a business connection will help UNA with future sales and build their confidence that external markets are within reach. We will continue to provide technical assistance to UNA and help them nurture this and other potential relationships.

In addition to finding suppliers and customers for individual firms, we have provided a connection for a business association, the Association of Plant Producers in Protected Areas (APPPA). The APPPA is interested in financing and organizing the greenhouse producers of Montenegro to act as a supplier for the quickly depleting National Park forest reserves. We are continuing to help this organization by offering technical assistance and resources through working with international consultants and individual firms in the industry. A scope of work has been defined and U.S. experts identified to provide support for organizational development, greenhouse development, and strategic development for sustainable agricultural production in the greenhouses.

Continuing Technical Assistance

The following projects have been earmarked for TA, with scopes of work already issued and some volunteer consultants already lined up.

- Marketing & Sales Strategy for Paint Manufacturer
- Strategic Plan for SME Development within the National Park system
- Technology & Marketing Strategy for Carpenter Craftsman
- Marketing & Sales Strategy for Aluminum Window/Door Manufacturer
- Strategic Plan including Organizational Management for Greenhouse producers in Montenegro
- Technology & Operations improvement for Stone Cutter
- Organizational Management & Strategy for Marketing Services

Seminars

FLAG conducted a large Business Planning seminar that attracted nearly 100 attendees. Contrary to the history of seminars in Montenegro, the majority of attendees were business owners. A great deal of interest was generated by the seminar and follow-up seminars are planned for the final quarter of the year. These seminars will focus on the particulars of financial statements and will be conducted over two days. The first day will focus on the need for accurate reporting on all three basic financial statements and on ways that management can use this financial information for analytical purposes. The second day of training will focus on establishing

accounting systems and using these systems to track costs so clients can better evaluate products based on production costs and can find ways to cut costs and thus increase their competitiveness.

Seminars are also planned in the final quarter targeted at accounting for private hotels and for accountants who work specifically with the hospitality industry. Private hotel owners, professional accountants, and managers of hotels will be invited to a five-day seminar on the Uniform Systems of Accounts – international accounting standards for the hospitality industry. This interactive training will expose Montenegrin business people to western style financial statements and show them how the statements can be used to manage their respective enterprises.

Cooperation (Capacity & Institutional Building)

In the past quarter, cooperation with a number of local and USAID sponsored agencies increased dramatically with the increase in FLAG Montenegro's SME development activities. Close collaboration with the Montenegrin Agency for SME Development has been at the heart of our program for sustainable economic development. With the Agency, we planned and implemented a two-day conference entitled "The Business Plan as an Efficient Management Tool." We have also created a work plan for future cooperation with the Agency. The core of the involvement will be using the Agency as an advocate for SMEs within the government and as a resource center for information on trade and management training.

We also worked to provide field training for local consultants from Opportunity International's Center for Entrepreneurship and Microcredit. Providing the necessary business training to individuals will help transfer knowledge and skills to the Montenegrin institutions that will provide the economic foundation and environment for future SMEs to flourish. Further work with OI involved assuming a supportive role for clients that graduated from the OI microcredit program and need more substantial financing. We have agreed with OI to provide business plans for these clients thus enabling them to continue a relationship with OI after Opportunity Bank is established.

KAP

KAP saw continued improvement in its operations and its ability to reduce the per tonne cost of aluminum produced. However, the falling price of aluminum on the London Metals Exchange (LME) has

hurt the plant's abilities to maintain its profits of earlier in the year. The most pressing problem remains its bloated work force and until this can be resolved, it will continue to drain KAP's income. The falling price on the LME also strained KAP's ability to stay within the boundaries set by the Debt Restructuring Agreement but, to date, KAP is in full compliance with this Agreement.

A number of programs to reorganize the management structure were implemented in this quarter. A cost analyst's office was established to provide support to operations and act as a link between operations and finance to keep costs in line with budget. The purchasing department was overhauled and an automated system implemented that closes many of the loopholes in a system that formerly allowed staff to conclude losing deals independently of KAP management.

Finance

The majority of the work in finance this quarter concentrated on reorganizing the staffing in the financial and accounting functions at KAP. The restaffing was necessary as mechanized systems are being introduced and accounting conducted in line with International Accounting Standards, and it is vital to have competent workers completing finance and accounting tasks. KAP continues its search for an appropriate Chief Financial Officer. Recruiting advertisements were published in the former quarter but respondents were either not fully qualified or not willing to work under KAP remuneration policies. Therefore, the position remains unfilled though the search continues.

A cost accountant was successfully recruited to work with KAP on setting up automated financial systems and organizing a cost accounting department. Work continues along these lines and will be finalized in the last quarter of CY 2001. This work will enable KAP to gain better control of its per tonne costs and provide more accurate and up-to-date financial statements.

Contract negotiations have begun on raw material inputs. Currently, KAP works under raw material contracts established by former government arrangements – and with preferred traders – that were made to support other state-run companies which provided inputs. KAP is now looking to make this process much more transparent, efficient, and international. Our management team researched and visited various suppliers worldwide and is currently working to finalize raw material contracts that will eliminate state monopolies on supplies and dramatically reduce costs to make KAP more competitive internationally. These contracts will be finalized via closed

bidding during the final quarter of CY 2001. It is estimated that the cost savings to KAP resulting from these contracts will be USD 4 - 7 million.

Operations

According to plan, refurbishments were to take place at a rate of USD 950,000 per month. These refurbishments have resulted in improvements that increased the production of aluminum to a new record of 9,200 tonnes per month, equivalent to a running rate of 112,000 tonnes per year. Due to the falling prices on the LME, however, plans for the final three months of CY 2001, have been adjusted downward to a monthly refurbishment budget of USD 750,000 for October and USD 500,000 for the two final months in the year. The substantial cost savings brought about by refurbishments already completed, however, will limit the impact of these reduced budgets.